

COMPARISON OF
PRESENT LAW AND H.R. 4065
Relating to the Tax Treatment of Life Insurance Companies
and Their Products

Prepared by the Staff of
the Joint Committee on Taxation
for Use by
the Committee on Ways and Means

October 5, 1983

JCX-32-83

J862-77
H782-48

INTRODUCTION

This document, prepared for use by the Committee on Ways and Means at its October 5, 1983, markup, provides a comparative description of present law and H.R. 4065 relating to the tax treatment of life insurance companies and their products, reported by the Subcommittee on Select Revenue Measures.

1. Structure of the Corporate Level Tax

Life insurance companies are taxed using a 3-phase approach.

Phase I taxes investment income currently.

Phase II taxes gain from operations--combining both investment income and underwriting gain or loss; if underwriting gain, only one-half is taxed currently.

Phase III taxes the untaxed underwriting gain if and when distributed to shareholders.

The 3-phase approach would be eliminated. However, current amounts in the policyholder surplus account (Phase III) would retain tax deferral until distributed, subject to the rules for distribution and tax under the 1959 Act. Life insurance companies would be taxed currently on life insurance company taxable income at the generally applicable corporate tax rates. The alternative tax on capital gains could apply.

Special rules would govern--

(1) the deduction for reserves (item 2, below);

(2) the deductibility of policyholder dividends (item 3, below);

(3) the treatment of small companies (item 5, below); and

(4) the aggregate tax burden on the industry generally (item 6, below).

Effective date.-- Taxable years beginning after December 31, 1983.

2. Policyholder Reserves

(a) In general

(a) In general.--Taxable income is computed by allowing, in effect, deductions for increases in the prior year-end reserves required under State law.

Special rules apply to--

(1) adjust reserves for purposes of the tax on investment income (the Menge formula);

(2) allow a revaluation of preliminary term reserves to net level reserves (sec. 818(c)); and

(3) provide additional contingency reserves for--

(i) nonparticipating policies, and

(ii) accident and health, and group life contracts.

(b) Life insurance reserves

(a) In general.--Companies would be allowed a deduction for reserve increases (reduced by the policyholders' share of tax-exempt interest (item 7 below)) for certain enumerated items.

(b) Life insurance reserves.--With respect to life insurance reserves for any contractual benefit, the amount of the increase would be to the higher of (1) the net surrender value, or (2) the reserve calculated using specified methods, interest rate, and mortality assumptions for such benefit. The rule against double counting would require aggregation of benefits where a net surrender value is properly allocable to more than one benefit.

(1) cash surrender
values

(1) the actual cash surrender value would be computed by reference to the provisions in the contract guaranteeing cash values, without regard to any market value adjustment on surrender.

(2) Federally computed
minimum reserve

(2) for purposes of calculating a reserve, different methods are provided for life insurance reserves on different types of contracts.

The permitted interest rate is the highest permitted in 26 States (in the year of issue or the preceding year).

The mortality assumptions required are the most recent adopted by at least 26 States (subject to a 3-year grace period in which a company would be required to give effect to a new table).

(c) Special rule for contracts issued by foreign branches

(c) Special rule for contracts issued by foreign branches.--With respect to contracts issued by foreign branches of domestic life insurance companies to residents of a foreign country, the minimum reserve required under foreign law where foreign law dictates the amount of the reserve would be the minimum reserve for tax purposes.

(d) Special rules for variable contracts

(d) Variable contracts.-- There are special rules which require separate accounting for asset funds underlying variable annuity contracts, but which do not apply to variable life insurance contracts. Under one specific rule, capital gains recognized by the company on the sale of assets underlying nonqualified annuity contracts are taxed at the company level, although the gains are credited to the policyholder (causing a double tax on such amounts when distributed and taxed again at the policyholder level).

(e) Special rule for group annuity contracts

(d) Variable contracts.--Special rules for the company tax treatment of variable contracts, in general, would be provided. A variable contract is defined as either an annuity or life insurance contract under which the policy benefits are adjusted to reflect the current investment return and current market value of a segregated asset fund. The provision would continue the present law tax treatment for variable annuities and would extend the same treatment to variable life insurance.

(e) Special rule for group annuity contracts.-- For purposes of computing the tax reserve, the bill would require that the date of group certificates issued to members of the group be taken into account.

With respect to group annuities, the balance in the policyholder's fund (determined without regard to any market value adjustment) would be treated as the net surrender value.

(f) Accident and health insurance contracts

(f) Accident and health insurance contracts.--Unearned premium and unpaid loss reserves are established in connection with these contracts. For purposes of the unearned premium reserve, gross premiums are earned pro rata over the life of the contract. Unpaid losses are estimated and reserved for on a non-discounted basis.

(f) Accident and health insurance contracts.--Present law tax treatment would be retained for unearned premiums and unpaid losses for accident and health contracts.

Effective date.--Taxable years beginning after December 31, 1983.

Transition rule.--Reserves would be recomputed under the new rules as of the close of 1983. Any income or loss arising from the recomputation would not be taken into account in computing taxable income of the companies.

3. Limitation on Deduction
for Policyholder Divi-
dends Paid by Mutual
Companies
("Ownership Differential")

(a) In general

(a) In general.--In computing taxable income, companies are allowed certain special deductions including the deductions for policyholder dividends, nonparticipating contracts, and A&H and group life contracts, subject to limitations.

(1) Under the permanent provisions of the 1959 Act, these special deductions cannot reduce taxable income below an amount equal to taxable investment income less a statutory amount of \$250,000 (Phase 1).

(2) Under the temporary provisions applicable to 1982 and 1983, a company can use (1) the 1959 Act rule with the \$250,000 statutory amount increased to \$1,000,000, targeted to smaller companies, or (2) a limitation equal to the statutory amount, plus 100 percent of dividends on pension business, plus 77-1/2 percent of nonpension policyholder dividends for mutual companies (85 percent for stocks).

(a) In general.--No limitation would be placed on the deduction of policyholder dividends or similar amounts by stock life insurance companies. Policyholder dividends would be defined to include excess interest, premium adjustments, and experience-rated refunds and would be deductible when paid or accrued rather than on the basis of reserves.

No special deductions for nonparticipating, A&H and group life contracts would be allowed.

The deduction for policyholder dividends paid by a mutual company would be reduced by an amount equal to a differential earnings rate on the company's equity base. If the reduction amounts exceed the amount of policyholder dividends paid by the company, the excess would offset any reserve deductions.

(b) Equity base

(b) Equity base.--Under the 1959 Act, assets held for policyholders in their capacity as owners of the company are not identified in any way. The Act does, however, distinguish between investment assets held with respect to liabilities to policyholders and other investment assets. Investment income earned on assets not held for liabilities to policyholders is taxed at the company level through the limitation in policyholder dividends.

(b) Equity base.--The equity base of a mutual would be measured and would equal its surplus and capital as shown for State regulatory purposes, with the following adjustments:

(1) nonadmitted financial assets would be included;

(2) reserves would be computed under the Federal tax rules;

(3) any mandatory securities valuation reserve, deficiency reserve, or voluntary reserve would be included; and

(4) 50 percent of any provision for policyholder dividends payable in the following year would be included.

In applying the differential earnings rate to a mutual company's equity base, such base would be reduced by the amount which is allocable to business conducted in noncontiguous countries in the Western Hemisphere. The reduction would be equal to the percentage of reserves allocable to such foreign business.

(c) Differential earnings rate

(c) Differential earnings rate.---The differential earnings rate would be the excess of the imputed pre-tax earnings rate of 16.5 percent for 1984 (adjusted annually to the numerical average rate of return earned by the 50 largest stock companies over a 3-year period) over the average mutual earnings rate for the second preceding calendar year.

(d) Adjustment in later year

(d) Adjustment in later year.--When actual data becomes available to compute the actual mutual earnings rate for a particular year, the differential earnings rate would be recomputed for such year and an adjustment (based on the equity base for such year) would be made on the tax return of the subsequent year.

Effective date.--Taxable years beginning after December 31, 1983.

A study of the life insurance industry would be required to review the appropriateness of the segment balance decision.

4. Stock Subsidiaries of
Mutual Companies

Present law does not directly distinguish between stock subsidiaries of stock and mutual life insurance companies.

Generally, a stock subsidiary of a mutual life insurance company would be treated as a stock company. However, the equity of 80-percent owned stock life subsidiaries would be included in the equity of the mutual parent for purposes of computing the reduction of the policyholder dividends deduction of the parent. Stock life subsidiaries would be treated as mutuals for purposes of computing the mutual earnings rate.

The same rules for filing consolidated returns would apply to both stocks and mutuals.

For both stock and mutual companies, dividends received from a stock subsidiary that is at least 80-percent owned would be deductible by the parent under rules generally applicable to other corporations. (Such dividends would not be subject to proration unless they are a distribution out of tax-exempt income.)

Effective date.--Taxable years beginning after December 31, 1983.

5. Treatment of Small Companies

There is a small company deduction of \$25,000 that is available to all companies. Also, although not limited to small companies, the deferral of tax on one-half of underwriting income, the revaluation of reserves under section 818(c), and the special deductions for non-participating and group life and A&H contracts significantly reduce the tax burden of many small companies.

For purposes of computing the limitation on the deduction for policyholder dividends and other special deductions under temporary provisions applicable for 1982 and 1983, the \$1 million statutory amount phases out as policyholder dividends and special deductions increase from \$4 million to \$8 million.

Small companies would be permitted a deduction equal to 60 percent of the first \$3 million of otherwise taxable income. This percentage figure would be reduced to zero as taxable income increases from \$3 million to \$15 million. Thus, the maximum benefit that could be enjoyed by a small company would be \$1.8 million, and a company with \$15 million or more in taxable income would not be entitled to any small company deduction.

Companies with more than \$500 million in assets would not qualify for the deduction. Eligibility would be determined on the basis of affiliated groups.

Effective date.--Taxable years beginning after December 31, 1983.

6. Taxable Income Adjustment
(Special Life Insurance
Company Deduction)

All life companies would be allowed a deduction in an amount equal to 25 percent of their taxable income arising out of insurance business. The deduction would apply after the deduction for policyholder dividends and small companies.

Effective date.--Taxable years beginning after December 31, 1983.

.7. Tax-Exempt Income

Annual additions of interest to policyholders' reserves are treated as funded proportionately out of taxable and tax-exempt income.

Tax-exempt interest and intercorporate dividends received deduction (not including dividends received that are 100 percent excludable) would be allocated to policyholders in the same proportion amounts paid or credited to policyholders as customers (i.e., required interest deductible policyholder dividends) bears to gross investment income less specified investment expenses.

Effective date.--Taxable years beginning after December 31, 1983.

8. Reinsurance

Present law prevents the avoidance of Federal income tax through reinsurance transactions by (1) denying a deduction for interest on reinsurance-related debt, (2) permitting Treasury to reallocate income and deductions in coinsurance transactions between related parties, and (3) treating policyholder dividends as paid by the primary insurer rather than the reinsurers.

Generally, present-law rules would be retained. However, the new provision giving Treasury reallocation authority in reinsurance agreements is broader than present law, adopting a broader definition of related parties and also extending the reallocation authority in a reinsurance agreement where one party is an agent of or conduit for the other.

Effective date.--Taxable years beginning after December 31, 1983.

However, with respect to the new provision on Treasury's reallocation authority, it would not apply with respect to contracts issued before September 27, 1983, reinsured before such date under a reinsurance agreement entered into before such date.

9. Foreign Tax Credit

Present law may distinguish between foreign and U.S. source income on a phase-by-phase basis. Thus, for example, a company taxed in Phase I may be able to claim a foreign tax credit only if it has a foreign source taxable investment income.

Deductions for policyholder dividends, reserve increases, and claims paid would reduce foreign and U.S. income (whether from investments or underwriting) pro rata.

Effective date.--Taxable years beginning after December 31, 1983.

10. Contiguous Country Branches of U.S. Life Companies

Income of Canadian and Mexican branches of U.S. life companies that benefits only policyholders is not subject to U.S. tax unless repatriated to the United States.

Generally, the same as present law.

Effective date.--Taxable years beginning after December 31, 1983.

11. Foreign Life Companies
--Minimum Surplus Adjustment

Foreign life companies that do not maintain U.S. surplus (U.S. assets less U.S. liabilities) comparable to U.S. companies' average surplus must reduce certain deductions.

Generally, the same as present law.

Effective date.--Taxable years beginning after December 31, 1983.

12. Definition of Life Insurance Companies

To qualify as a life insurance company, a company must hold more than 50 percent of its reserves as life insurance reserves. It is unclear how pension funds without permanent life annuity purchase rate guarantees should be treated. Under the temporary provisions for 1982 and 1983, no company is allowed to change its life company status because of its treatment of such pension funds.

Generally, the present law definition would be retained. Reserves on pension funds without permanent life annuity purchase rate guarantees would not be treated as insurance reserves for purposes of the 50 percent qualification test.

Effective date.--Taxable years beginning after December 31, 1983.

13. Consolidation with Other Companies

Generally, life insurance companies are permitted to join with other companies in the filing of a consolidated return. Special rules apply, however, to limit the extent to which nonlife insurance losses can be used to offset life insurance income.

Generally, the present-law rules would be retained. In addition, it would be specifically provided that gains or losses of nonlife insurance members of an affiliated group would not be taken into account in determining the amount of the special deductions for the life insurance members of the group.

Effective date.--Taxable years beginning after December 31, 1983.

14. Accounting Rules

Federal tax accrual accounting rules would have primacy over State statutory accounting rules. State rules would apply to the extent consistent with, or required by, Federal tax rules. The holding of the Supreme Court in Comm'r. v. Standard Life and Accident Ins. Co., 433 U.S. 148 (1977), would, in effect, be reversed.

15. Definition of Life Insurance

(a) In general

(a) In general.--There is no statutory definition of "insurance" or "life insurance." Death proceeds paid under a life insurance contract to a beneficiary are exempt from income tax. Income earned on the cash surrender value of a contract is not taxed currently to the policyholder, and is taxed upon termination of the contract prior to death to the extent the cash surrender value exceeds the policyholders' investment in the contract (the aggregate premiums paid).

Temporary guidelines

For 1983 and 1984, death proceeds from flexible premium policies (e.g., universal life) are treated as life insurance if either of two tests are met.

Premium/Corridor Test

(a) Premiums paid for the benefit cannot exceed the single premium (at 6 percent) or the sum of the level premiums (at 4 percent), assuming the policy matures no earlier than 20 years or age 95, if earlier, and

(a) In general.--There would be a statutory definition of life insurance for tax purposes.

Using the pattern of the temporary guidelines, contracts would qualify as life insurance contracts under either of two tests:

Premium/Corridor Test

(a) Premiums paid could not exceed the single premium (at 6 percent) or the sum of the level premiums (at 4 percent) that would be paid for a level death benefit under a contract maturing no earlier than at age 95, and

(b) the death benefit must be at least 140 percent of cash value at age 40, phasing down each year to 105 percent (corridor limitation).

Cash Value Test

The cash value cannot exceed the net single premium (at 4 percent) for the amount payable at death, assuming the policy matures no earlier than 20 years or age 95, if earlier.

(b) Consequences of failure.--Under an IRS ruling, contracts that fail to meet such guidelines are treated as a combination of term life insurance and an annuity.

(b) the death benefit must be at least 250 percent of cash value at age 40, phasing down (in accordance with a table of percentages) to 100 percent at age 95.

Cash Value Test

The cash value could not exceed the net single premium (at 4 percent) for a level death benefit under a contract maturing no earlier than age 95.

(b) Consequences of failure.--Contracts that fail would be treated as a combination of term life insurance and a currently taxable deposit fund.

Effective date.--The provision is effective for contracts issued after December 31, 1983.

Transition rule.--For contracts issued during 1984, such contracts would qualify if they meet the present-law flexible premium tests or, if not a flexible premium contract, they would meet the new definition by substituting 3 percent for 4 percent in the cash value test.

Also, existing plans of insurance that have at least a 20-pay premium requirement, would be grandfathered if they meet the second part of the transition rule described above.

(b) Consequences of failure

Item

Present Law

16. Annuity Contracts

(a) In general

(a) In general.--After the annuity starting date (the payout phase) each payment is treated as part a payment of income out of the contract and part a return of capital (the policyholder's investment in the contract).

Distributions prior to the annuity starting date are treated as being made first out of income and then as out of the policyholder's investment in the contract.

(a) In general.--Present law would be retained with respect to the taxation of income from an annuity contract.

(b) Penalty on premature distributions

(b) Penalty on premature distributions.--Premature distributions from annuity contracts are subject to a penalty tax equal to 5 percent of the amount includible in income.

(b) Penalty on premature distributions.--Same as present law.

(c) Definition of
premature
distributions

(c) Definition of premature distributions.--A distribution (including a loan or partial surrender) is treated as premature if made before the annuitant reaches age 59-1/2 and if the income portion of the distribution is attributable to an investment made within 10 years of the distribution.

Exceptions are provided for:

- (1) distributions at death;
- (2) distributions on account of disability;
- (3) distributions under an annuity for life or at least 5 years;
- (4) distributions under a qualified pension plan; and
- (5) distributions allocable to pre-August 14, 1982, investments.

(c) Definition of premature distributions.--The exception from the penalty for income on investments held more than 10-years would be eliminated.

Also, a new rule would be adopted that, if the annuity has not been annuitized upon the death of the contract-holder, the income in the contract will be taxable upon such death and includible in the final return of the contractholder.

Effective date.--Date of enactment.

17. Policyholder Loans

No deduction is allowed for:

(1) interest paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan which contemplates the systematic direct or indirect borrowing of part of all of the increases in the cash value of such a contract;

(2) interest paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment or annuity contract; and

(3) premiums paid on any policy covering the life of any officer, employee or financially interested person, when the taxpayer is a beneficiary.

An exception is provided to the rule disallowing amounts paid or accrued on indebtedness incurred or continued as part of a plan if--

(1) no part of four of the first seven annual premiums is paid by means of indebtedness; or

Generally, present law would continue to apply. However, a limitation would be placed on the amount of deductible interest paid on policy loans. Individual policyholders would be allowed \$250,000 (\$500,000 for a joint return) times the deficiency rate; businesses, \$500,000 times the number of qualifying individuals times the deficiency rate.

The term "qualifying individual" would be defined by reference to the amount of coverage provided as a percentage of the maximum amount provided under a policy owned by the company. Only individuals covered by whole-life cash value policies would be considered qualifying individuals.

There would also be carryover rules for unused deduction limitations.

Effective date.--The new provision would apply only to policies issued after September 27, 1983.

(2) the total of the amounts paid or accrued during the taxable year and for which no deduction would be available do not exceed \$100; or

(3) the indebtedness was incurred because of an unforeseen substantial loss of income or increases in financial obligations; or

(4) the indebtedness was incurred in connection with the taxpayer's trade or business.

13. Group-Term Insurance

(a) In general

(a) In general.--Under present law, an employee can exclude from income the cost of \$50,000 of group-term life insurance under a policy (or policies) carried by the taxpayer's employer (or employers). Retired employees do not have to include the cost of group-term insurance at all. Cost of group-term life insurance is determined on the basis of uniform cost table prescribed by regulations.

(b) Nondiscrimination requirements on

(b) Nondiscrimination requirements.--The exclusion is not available to key employees covered under discriminatory group-term life insurance plans.

(a) In general.--Retired employees would be subject to the \$50,000 cap on exclusion from income or group-term insurance.

(b) Nondiscrimination requirements.--The nondiscrimination rules will be extended to retired employees.

Employees or retired employees disqualified under discriminatory plans would not be able to use the uniform cost table.

Effective date.--New provision would not apply to plans of group-term insurance in existence on September 27, 1983, with respect to the individual employees covered and for the amount of coverage on such date.